GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

October 13, 2000

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce

The Honorable Ron Klink
Ranking Minority Member, Subcommittee on Oversight and Investigations
Committee on Commerce

The Honorable Edward J. Markey
Ranking Minority Member, Subcommittee on Telecommunications, Trade and Consumer Protection
Committee on Commerce

The Honorable Edolphus Towns
Ranking Minority Member, Subcommittee on Finance and Hazardous Materials
Committee on Commerce
House of Representatives

This letter responds to your request that we address issues raised by the Securities Industry Association (SIA) about recommendations contained in our May 2000 report, On-line Trading: Better Investor Protection Information Needed on Brokers' Web Sites (GAO/GGD-00-42). Specifically, we recommended that the Securities and Exchange Commission (SEC) require broker-dealers with on-line trading systems to maintain consistent records on system delays and outages and to disclose on their Web sites the potential for service disruptions. We also recommended that SEC ensure that on-line brokers include information on their Web sites about key investor protection areas, such as margin requirements, privacy policies, trading risks, and best execution of trades.

SIA characterized our report's recommendations as premature because of work that two committees, SIA's Online Brokerage Committee and NASD Regulation's E-Brokerage Committee, have been doing throughout this year to develop best practice recommendations concerning customer education, disclosure, and on-line brokerage. SIA also said the focus of our report was misplaced because the distinction between on-line and traditional firms is disappearing, operational functions are common to all broker-dealers, and it does not make sense to adopt regulations directed at one channel of customer access.

One of the reasons we made these recommendations was that on-line investors were experiencing problems with trading system outages and delays, and officials from several large broker-dealers anticipated such disruptions to continue as firms expand or upgrade their systems. Yet, we found that broker-dealers offering on-line trading neither consistently monitored these disruptions nor disclosed that such disruptions could occur. We continue to strongly believe that maintaining consistent records about delays and outages could provide the broker-dealers information that could be used to better inform investors about the potential for, and adverse effects of, delays and outages. The information could also assist securities regulators in assessing whether these broker-dealers comply with SEC guidance on maintaining adequate system capacity.

We also made these recommendations because investor complaints to SEC showed that many on-line investors did not understand the risks they were taking or the rules and procedures for trading. For example, investors at broker-dealers in our review were unaware of the potential for system disruptions to affect the processing of their trades. Also, many investors were not aware that their margin positions could be sold before the customary 3-day period provided by broker-dealers to replenish the equity in the investor's accounts. Without adequate knowledge on trading and its risks, as well as information on the limitations of on-line trading systems, investors have experienced financial loss. By being able to access clear and complete information on the Web sites of broker-dealers with on-line trading systems, investors could better understand their risks and the on-line trading operations of broker-dealers.

Our report focused exclusively on on-line trading to address our requestors' concerns in a timely fashion. However, it discusses how some of the distinctions between on-line and full-service brokers are blurring, and we obtained information from both broker-dealers that provide only on-line trading and traditional broker-dealers that were beginning to offer these services. We found that both types of broker-dealers faced the same challenges in providing their customers on-line trading services. We recognize that although operational problems with delays and outages and best execution of trades may be more transparent in on-line trading, they also exist in other ways investors chose to execute trades in the securities industry, such as contacting their brokers by telephone. We also recognize that although our report's recommendations are focused on the on-line trading industry, this does not preclude SEC from addressing these problems industrywide or from considering industry actions, such as implementing appropriate and effective best practices to resolve the problems.

Ensuring that on-line investors understand the risks and processes of their trading is critical to helping them make informed investment decisions. These investors are responsible for their own trading decisions, which they make in the absence of solicitations and recommendations by a broker-dealer. In addition, the number of investors trading on-line had been increasing rapidly at the time of our report, with an additional 8 million investors expected to be trading on-line by the end of 2000. Timely implementation of our recommendations is needed to help ensure that these investors have access to all the information they need.

We look forward to working with you to assess the SIA proposals and will contact your staff about our plans for that work. If you have any further questions, please call me at 202-512-8678 or Mike Burnett, Assistant Director, at 202-512-7328.

Richard J. Hillman

Richard J. Hillman, Director
Financial Markets and Community Investment